FRANCHISE TAX BOARD

Title 18, Division 3, California Code of Regulations
Amend Article 2. Definitions, at Sections 23038(b)-1, 23038(b)-2, and 23038(b)-3; and
Adopt Article 2. Definitions, containing new Section 23038(b)-5

Final Text of Proposed Regulations

Chapter 3.5. Bank and Corporation Tax (Taxable Years Beginning After 12-31-54)
Subchapter 1. General Provisions and Definitions
Article 2. Definitions

Section 23038(b)-1 is amended to read:

§ 23038(b)-1. Classification of Organizations for California Income and Franchise Tax Purposes

(a) Organizations for California income and franchise tax purposes -- (1) In general. The Revenue and Taxation Code prescribes the classification of various organizations for California income and franchise tax purposes. Whether an organization is an entity separate from its owners for California income and franchise tax purposes is a matter of California income and franchise tax law and does not depend on whether the organization is recognized as an entity under local law.

(2) Certain joint undertakings give rise to entities for California income and franchise tax purposes. A joint venture or other contractual arrangement may create a separate entity for California income and franchise tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity exists for California income and franchise tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for California income and franchise tax purposes. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for California income and franchise tax purposes. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for California income and franchise tax purposes. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for California income and franchise tax purposes.

(3) Certain local law entities not recognized. An entity formed under local law is not always recognized as a separate entity for California income and franchise tax purposes. For example, an organization wholly owned by a State is not recognized as a separate entity for California income and franchise tax purposes if it is an integral part of the State. Similarly, tribes incorporated under section 17 of the Indian Reorganization Act of 1934, as amended, 25 U.S.C. §477, or under section 3 of the Oklahoma Indian Welfare Act, as amended, 25 U.S.C. §503, are not recognized as separate entities for California income and franchise tax purposes.

(4) Single owner organizations. Under Regs. §23038(b)-2 and §23038(b)-3, certain organizations that have a single owner can choose to be recognized or disregarded as entities separate from their owners, subject to certain statutory provisions which recognize the existence of otherwise disregarded entities for certain purposes including the tax and fee of a limited company under Sections 17941 and 17942 of the Revenue and Taxation Code, the return filing requirements of a limited liability company under Section 18633.5 of the Revenue and Taxation Code, and the

credit limitations of a disregarded entity under Sections 17039 and 23036 of the Revenue and Taxation Code.

(b) Classification of organizations. The classification of organizations that are recognized as separate entities is determined under Regs. §23038(b)-2, §23038(b)-3, and §23038(a)(3) unless a provision of the Revenue and Taxation Code (such as section 860A of the Internal Revenue Code addressing Real Estate Mortgage Investment Conduits (REMICs), as applicable for California purposes pursuant to section 24870 of the Revenue and Taxation Code) provides for special treatment of that organization. For the classification of organizations as trusts, see Reg. §23038(a)(3). That regulation provides that trusts generally do not have associates or an objective to carry on business for profit. Regulations §23038(b)-2 and §23038(b)-3 provide rules for classifying organizations that are not classified as trusts.

(c) ~~Qualified c~~Cost sharing arrangements. A ~~qualified~~ cost sharing arrangement ("CSA") that is described in Treas. Regs. §1.482-7 ~~and any arrangement that is treated by the Commissioner as a qualified cost sharing arrangement under Treas. Reg. §1.482-7~~, including any arrangement that the Commissioner treats as a CSA under Treas. Regs. § 1.482-7(b)(5), as applicable for California income and franchise tax purposes pursuant to Sections 23051.5 and 24725 of the Revenue and Taxation Code (except as provided in Article 1.5 of Chapter 17 of the ~~Bank and~~ Corporation Tax Law, commencing with Section 25101 of the Revenue and Taxation Code), is not recognized as a separate entity for purposes of the Revenue and Taxation Code. See Treas. Regs §1.482-7 for the ~~proper treatment of qualified cost sharing arrangements~~ rules regarding CSAs.

(d) Domestic and foreign business entities. ~~For purposes of this regulation and Regs. §23038(b)-2 and §23038(b)-3, an entity is a domestic entity if it is created or organized in the United States or under the laws of the United States or of any state; an entity is foreign if it is not domestic.~~ See Reg. § 23038(b)-5 for the rules that determine whether a business entity is domestic or foreign.

(e) State. For purposes of this regulation and Reg. §23038(b)-2, the term state includes the District of Columbia.

(f) Effective/applicability dates. Except as provided in the following sentence, ~~T~~this regulation is effective for taxable or income years commencing on or after January 1, 1997. The rules of subsection (c) of this regulation are applicable on January 5, 2009.

Note: Authority cited: Sections 19503 and 23038, Revenue and Taxation Code.
Reference: Sections 17039, 17941, 18633.5, 23036 and 23038, Revenue and Taxation Code.

Section 23038(b)-2 is amended to read:

§ 23038(b)-2. Business Entities; Definitions

(a) Business entities. For purposes of this regulation and Reg. §23038(b)-3, a business entity is any entity recognized for California income and franchise tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under Reg. §23038(b)-3) that is not properly classified as a trust under Reg. §23038(a)(3) or otherwise subject to special treatment under the Revenue and Taxation Code. A business entity with two or more members is classified for California income and franchise tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as an association taxable as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.

(b) Corporations. For purposes of the tax imposed under Chapter 3 of the Revenue and Taxation Code (commencing with Revenue and Taxation Code section 23501), the term corporation includes--

(1) A business entity organized under a federal or state statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic;

(2) An association (as determined under Reg. §23038(b)-3);

(3) A business entity organized under a state statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association;

(4) [reserved];

(5) [reserved];

(6) [reserved];

(7) A business entity that is taxable as a corporation under a provision of the Revenue and Taxation Code other than subdivision (b) of Section 23038; and

(8) Certain foreign entities--(A) In general. Except as provided in subsections (b)(8)(B) and (d) of this regulation, the following business entities formed in the following jurisdictions:

American Samoa, Corporation
Argentina, Sociedad Anonima
Australia, Public Limited Company
Austria, Aktiengesellschaft

Barbados, Limited Company
Belgium, Societe Anonyme
Belize, Public Limited Company
Bolivia, Sociedad Anonima
Brazil, Sociedade Anonima
Bulgaria, Aktsionerno Druzhestvo
Canada, Corporation and Company

Chile, Sociedad Anonima
People's Republic of China, Gufen Youxian Gongsi
Republic of China (Taiwan), Ku-fen Yu-hsien Kung-szu
Columbia, Sociedad Anonima
Costa Rica, Sociedad Anonima
Cyprus, Public Limited Company
Czech Republic, Akciova Spolecnost

Denmark, Aktieselskab

Ecuador, Sociedad Anonima or Compania Anonima
Egypt, Sharikat Al-Mossahamah
El Salvador, Sociedad Anonima
Estonia, Aktsiaselts
European Economic Area/European Union, Societas Europaea

Finland, Julkinen Osakeyhtio/Publikt Aktiebolag
France, Societe Anonyme

Germany, Aktiengesellschaft
Greece, Anonymos Etairia
Guam, Corporation
Guatemala, Sociedad Anonima
Guyana, Public Limited Company

Honduras, Sociedad Anonima
Hong Kong, Public Limited Company
Hungary, Reszvenytarsasag

Iceland, Hlutafelag
India, Public Limited Company
Indonesia, Perseroan Terbuka
Ireland, Public Limited Company
Israel, Public Limited Company
Italy, Societa per Azioni

Jamaica, Public Limited Company
Japan, Kabushiki Kaisha

Kazakstan, Ashyk Aktsionerlik Kogham
Republic of Korea, Chusik Hoesa

Latvia, Akciju Sabiedriba
Liberia, Corporation
Liechtenstein, Aktiengesellschaft
Lithuania, Akcine Bendroves
Luxembourg, Societe Anonyme

Malaysia, Berhad
Malta, ~~Partnership Anonyme~~ Public Limited Company
Mexico, Sociedad Anonima

Morocco, Societe Anonyme

Netherlands, Naamloze Vennootschap
New Zealand, Limited Company
Nicaragua, Compania Anonima
Nigeria, Public Limited Company
Northern Mariana Islands, Corporation
Norway, Allment Aksjeselskap

Pakistan, Public Limited Company
Panama, Sociedad Anonima
Paraguay, Sociedad Anonima
Peru, Sociedad Anonima
Philippines, Stock Corporation
Poland, Spolka Akcyjna
Portugal, Sociedade Anonima
Puerto Rico, Corporation

Romania, Societe pe Actiuni
Russia, Otkrytoye Aktsionernoy Obshchestvo

Saudi Arabia, Sharikat Al-Mossahamah
Singapore, Public Limited Company
Slovak Republic, Akciova Spolocnost
Slovenia, Delniska Druzba
South Africa, Public Limited Company
Spain, Sociedad Anonima
Surinam, Naamloze Vennootschap
Sweden, Publika Aktiebolag
Switzerland, Aktiengesellschaft

Thailand, Borisat Chamkad (Mahachon)
Trinidad and Tobago, ~~Public~~ Limited Company
Tunisia, Societe Anonyme
Turkey, Anonim Sirket

Ukraine, Aktsionerne Tovaristvo Vidkritogo Tipu
United Kingdom, Public Limited Company
United States Virgin Islands, Corporation
Uruguay, Sociedad Anonima

Venezuela, Sociedad Anonima or Compania Anonima

(B) Clarification of list of corporations in subsection (b)(8)(A) of this regulation – 1. Exceptions in certain cases. The following entities will not be treated as corporations under subsection (b)(8)(A) of this regulation:

~~1.~~a. With regard to Canada, ~~any corporation or company formed under any federal or provincial law which provides that the liability of all of the members of such corporation or company will be~~

~~unlimited; and~~ a Nova Scotia Unlimited Liability Company (or any other company or corporation all of whose owners have unlimited liability pursuant to federal or provincial law).

~~2.~~b. With regard to India, a company deemed to be a public limited company solely by operation of Section 43A(1) of the Internal Revenue Code (relating to corporate ownership of the company), Section 43A(1A) of the Internal Revenue Code (relating to annual average turnover), or Section 43A(1B) of the Internal Revenue Code (relating to ownership interests in other companies) of the Companies Act, 1956 (or any combination of these), provided that the organizational documents of such deemed public limited company continue to meet the requirements of Section 3(1)(iii) of the Companies Act, 1956.

c. With regard to Malaysia, a Sendirian Berhad.

2. Inclusions in certain cases. With regard to Mexico, the term Sociedad Anonima includes a Sociedad Anonima that chooses to apply the variable capital provision of Mexican corporate law (Sociedad Anonima de Capital Variable).

(C) Public companies. For purposes of subsection (b)(8)(A) of this regulation, ~~W~~with regard to Cyprus, Hong Kong, and Jamaica, ~~and Trinidad and Tobago,~~ the term ~~p~~Public ~~l~~Limited ~~c~~Company includes any ~~l~~Limited ~~c~~Company ~~which~~ that is not defined as a private ~~limited~~ company under the corporate laws of those jurisdictions. In all other cases, where the term Public Limited Company is not defined, that term shall include any Limited Company defined as a public company under the corporate laws of the relevant jurisdiction.

(D) Limited companies. ~~Any reference to a limited company (whether public or private) in subsection (b)(8)(A) of this regulation~~ For purposes of this subsection (b)(8), any reference to a Limited Company includes, as the case may be, companies limited by shares and companies limited by guarantee.

(E) Multilingual countries. Different linguistic renderings of the name of an entity listed in subsection (b)(8)(A) of this regulation shall be disregarded. For example, an entity formed under the laws of Switzerland as a Societe Anonyme will be a corporation and treated in the same manner as an Aktiengesellschaft.

(9) Business entities with multiple charters. (A) An entity created or organized under the laws of more than one jurisdiction if the rules of this regulation would treat it as a corporation with reference to any one of the jurisdictions in which it is created or organized. Such an entity may elect its classification under Treas. Regs. § 301.7701-3, subject to the limitations of those provisions, only if it is created or organized in each jurisdiction in a manner that meets the definition of an eligible entity in Reg. § 23038(b)-3(a). The determination of a business entity's corporate or non-corporate classification is made independently from the determination of whether the entity is domestic or foreign. See Reg. § 23038(b)-5 for the rules that determine whether a business entity is domestic or foreign.

(B) Examples. The following examples illustrate the rule of this subsection (b)(9):

Example 1. (i) Facts. X is an entity with a single owner organized under the laws of Country A as an entity that is listed in subsection (b)(8)(A) of this regulation. Under the rules of this regulation, such an entity is a corporation for California income and franchise tax purposes and under Reg. § 23038(b)-3(a) is unable to elect its classification. Several years after its formation, X files a certificate of domestication in State B as a limited liability company (LLC). Under the laws of State

B, X is considered to be created or organized in State B as an LLC upon the filing of the certificate of domestication and is therefore subject to the laws of State B. Under the rules of this regulation and Reg. § 23038(b)-3, an LLC with a single owner organized only in State B is disregarded as an entity separate from its owner for California income and franchise tax purposes (absent an election to be treated as an association). Neither Country A nor State B law requires X to terminate its charter in Country A as a result of the domestication, and in fact X does not terminate its Country A charter. Consequently, X is now organized in more than one jurisdiction.

(ii) Result. X remains organized under the laws of Country A as an entity that is listed in subsection (b)(8)(A) of this regulation, and as such, it is an entity that is treated as a corporation under the rules of this regulation. Therefore, X is a corporation for California income and franchise tax purposes because the rules of this regulation would treat X as a corporation with reference to one of the jurisdictions in which it is created or organized. Because X is organized in Country A in a manner that does not meet the definition of an eligible entity in Reg. § 23038(b)-3(a), it is unable to elect its classification.

Example 2. (i) Facts. Y is an entity that is incorporated under the laws of State A and has two shareholders. Under the rules of this regulation, an entity incorporated under the laws of State A is a corporation for California income and franchise tax purposes and under Reg. § 23038(b)-3(a) is unable to elect its classification. Several years after its formation, Y files a certificate of continuance in Country B as an unlimited company. Under the laws of Country B, upon filing a certificate of continuance, Y is treated as organized in Country B. Under the rules of this regulation and Reg. § 23038(b)-3, an unlimited company organized only in Country B that has more than one owner is treated as a partnership for California income and franchise tax purposes (absent an election to be treated as an association). Neither State A nor Country B law requires Y to terminate its charter in State A as a result of the continuance, and in fact Y does not terminate its State A charter. Consequently, Y is now organized in more than one jurisdiction.

(ii) Result. Y remains organized in State A as a corporation, an entity that is treated as a corporation under the rules of this regulation. Therefore, Y is a corporation for California income and franchise tax purposes because the rules of this regulation would treat Y as a corporation with reference to one of the jurisdictions in which it is created or organized. Because Y is organized in State A in a manner that does not meet the definition of an eligible entity in Reg. § 23038(b)-3(a), it is unable to elect its classification.

Example 3. (i) Facts. Z is an entity that has more than one owner and that is recognized under the laws of Country A as an unlimited company organized in Country A. Z is organized in Country A in a manner that meets the definition of an eligible entity in Reg. § 23038(b)-3(a). Under the rules of this regulation and Reg. § 23038(b)-3, an unlimited company organized only in Country A with more than one owner is treated as a partnership for California income and franchise tax purposes (absent an election to be treated as an association). At the time Z was formed, it was also organized as a private limited company under the laws of Country B. Z is organized in Country B in a manner that meets the definition of an eligible entity in Reg. § 23038(b)-3(a). Under the rules of this regulation and Reg. § 23038(b)-3, a private limited company organized only in Country B is treated as a corporation for California income and franchise tax purposes (absent an election to be treated as a partnership). Thus, Z is organized in more than one jurisdiction. Z has not made any entity classification elections under Reg. § 23038(b)-3.

(ii) Result. Z is organized in Country B as a private limited company, an entity that is treated (absent an election to the contrary) as a corporation under the rules of this regulation. However, because Z is organized in each jurisdiction in a manner that meets the definition of an eligible

entity in Reg. § 23038(b)-3(a), it may elect its classification under Reg. § 23038(b)-3, subject to the limitations of those provisions.

Example 4. (i) Facts. P is an entity with more than one owner organized in Country A as a general partnership. Under the rules of this regulation and Reg. § 23038(b)-3, an eligible entity with more than one owner in Country A is treated as a partnership for California income and franchise tax purposes (absent an election to be treated as an association). P files a certificate of continuance in Country B as an unlimited company. Under the rules of this regulation and Reg. § 23038(b)-3, an unlimited company in Country B with more than one owner is treated as a partnership for California income and franchise tax purposes (absent an election to be treated as an association). P is not required under either the laws of Country A or Country B to terminate the general partnership in Country A, and in fact P does not terminate its Country A partnership. P is now organized in more than one jurisdiction. P has not made any entity classification elections under Reg. § 23038(b)-3.

(ii) Result. P's organization in both Country A and Country B would result in P being classified as a partnership. Therefore, since the rules of this regulation would not treat P as a corporation with reference to any jurisdiction in which it is created or organized, it is not a corporation for California income and franchise tax purposes.

(c) Other business entities. (1) For California income and franchise tax purposes, the term partnership means a business entity that is not a corporation under subsection (b) of this regulation and that has at least two members.

(2) Wholly owned entities -- (A) In general. Except as otherwise provided in this paragraph (c), A~~a~~a business entity that has a single owner and is not a corporation under subsection (b) of this regulation is disregarded as an entity separate from its owner for purposes of Part 10 (Personal Income Tax Law commencing with Revenue and Taxation Code section 17001), Part 10.2 (Administration of Franchise and Income Tax Law commencing with Revenue and Taxation Code section 18401), and Part 11 (Corporation Tax Law commencing with Revenue and Taxation Code section 23001), subject to certain statutory provisions which recognize the existence of otherwise disregarded entities for certain purposes including the tax and fee of a limited liability company under Revenue and Taxation Code sections 17941 and 17942, the return filing requirements of a limited liability company under Revenue and Taxation Code section 18633.5, and the credit limitations of a disregarded entity under Revenue and Taxation Code sections 17039 and 23036.

(B) Special rule for certain business entities. If the single owner of a business entity is a bank (as defined in Revenue and Taxation Code section 23039), then the special rules applicable to banks will continue to apply to the single owner as if the wholly owned entity were a separate entity. For this purpose, the special rules applicable to banks under the Internal Revenue Code do not include the rules under sections 864(c) and 882(c) of the Internal Revenue Code.

(C) Tax liabilities of certain disregarded entities – 1. In general. An entity that is disregarded as separate from its owner for any purpose under this regulation is treated as an entity separate from its owner for purposes of--

a. California income and franchise tax liabilities of the entity with respect to any taxable period for which the entity was not disregarded;

b. California income and franchise tax liabilities of any other entity for which the entity is liable; and

c. Refunds or credits of California income and franchise tax.

(D) Examples. The following examples illustrate the application of subsection (c)(2)(C)1. of this regulation:

Example 1. In 2006, X, a domestic corporation that reports its taxes on a calendar year basis, merges into Z, a domestic LLC wholly owned by Y that is disregarded as an entity separate from Y, in a state law merger. X was not a member of a combined reporting group at any time during its taxable year ending in December 2005. Under the applicable state law, Z is the successor to X and is liable for all of X's debts. In 2009, the Franchise Tax Board (FTB) seeks to extend the period of limitations on assessment for X's 2005 taxable year. Because Z is the successor to X and is liable for X's 2005 taxes that remain unpaid, Z is the proper party to sign the consent to extend the period of limitations.

Example 2. The facts are the same as in Example 1, except that in 2007, the IRS determines that X miscalculated and underreported its income tax liability for 2005. Because Z is the successor to X and is liable for X's 2005 taxes that remain unpaid, the deficiency may be assessed against Z and, in the event that Z fails to pay the liability after notice and demand, a general tax lien will arise against all of Z's property and rights to property.

(d) Special rule for certain foreign business entities--(1) In general. Except as provided in subsection (d)(3) of this regulation, a foreign business entity described in subsection (b)(8)(A) of this regulation will not be treated as a corporation under subsection (b)(8)(A) of this regulation if--

(A) The entity was in existence on May 8, 1996;

(B) The entity's classification was relevant (as defined in Reg. §23038(b)-3(d)) on May 8, 1996;

(C) No person (including the entity) for whom the entity's classification was relevant on May 8, 1996, treats the entity as a corporation for purposes of filing such person's California income tax returns, information returns, and withholding documents for the taxable year including May 8, 1996;

(D) Any change in the entity's claimed classification within the sixty months prior to May 8, 1996, occurred solely as a result of a change in the organizational documents of the entity, and the entity and all members of the entity recognized the California income tax consequences of any change in the entity's classification within the sixty months prior to May 8, 1996;

(E) A reasonable basis (within the meaning of Section 6662 of the Internal Revenue Code) existed on May 8, 1996, for treating the entity as other than a corporation; and

(F) Neither the entity nor any member was notified in writing on or before May 8, 1996, that the classification of the entity was under examination (in which case the entity's classification will be determined in the examination).

(2) Binding contract rule. If a foreign business entity described in subsection (b)(8)(A) of this regulation is formed after May 8, 1996, pursuant to a written binding contract (including an accepted bid to develop a project) in effect on May 8, 1996, and at all times thereafter, in which the parties agreed to engage (directly or indirectly) in an active and substantial business operation

in the jurisdiction in which the entity is formed, subsection (d)(1) of this regulation will be applied to that entity by substituting the date of the entity's formation for May 8, 1996.

(3) Termination of grandfather status--(A) In general. An entity that is not treated as a corporation under subsection (b)(8)(A) of this regulation by reason of subsection (d)(1) or (d)(2) of this regulation will be treated permanently as a corporation under subsection (b)(8)(A) of this regulation from the earliest of:

1. The effective date of an election to be treated as an association under Reg. §23038(b)-3;

2. A termination of the partnership under Section 708(b)(1)(B) of the Internal Revenue Code (regarding sale or exchange of 50 percent or more of the total interest in an entity's capital or profits within a twelve month period); ~~or~~

3. A division of the partnership under Section 708(b)(2)(B) of the Internal Revenue Code~~.~~ ; or

4. The date any person or persons, who were not owners of the entity as of November 29, 1999, own in the aggregate a 50 percent or greater interest in the entity.

(B) Special rule for certain entities. For purposes of subsection (d)(2) of this regulation, subsection (d)(3)(A)2. of this regulation shall not apply if the sale or exchange of interest in the entity is to a related person (within the meaning of Sections 267(b) and 707(b) of the Internal Revenue Code) and occurs no later than twelve months after the date of the formation of the entity.

(e) Effective/applicability date. ~~The rules of this regulation are effective for taxable or income years commencing on or after January 1, 1997.~~ (1) Except as otherwise provided in this subsection (e), the rules of this regulation apply as of January 1, 1997, except that subsection (c)(2)(B) of this regulation applies to taxable years beginning after January 12, 2001. The reference to the Finnish, Maltese, and Norwegian entities in subsection (b)(8)(A) of this regulation is applicable on November 29, 1999. The reference to the Trinidadian entity in subsection (b)(8)(A) of this regulation applies to entities formed on or after November 29, 1999. Any Maltese or Norwegian entity that becomes an eligible entity as a result of subsection (b)(8)(A) of this regulation in effect on November 29, 1999, may elect by February 14, 2000, to be classified for Federal tax purposes as an entity other than a corporation retroactive to any period from and including January 1, 1997. Any Finnish entity that becomes an eligible entity as a result of subsection (b)(8)(A) of this regulation in effect on November 29, 1999, may elect by February 14, 2000, to be classified for Federal tax purposes as an entity other than a corporation retroactive to any period from and including September 1, 1997. However, subsection (d)(3)(A)4. of this regulation applies on or after October 22, 2003.

(2) Subsection (c)(2)(C) of this regulation applies on and after September 14, 2009.

(3)(A) General rule. Except as provided in subsection (e)(3)(B) of this regulation, the rules of subsection (b)(9) of this regulation apply as of August 12, 2004, to all business entities existing on or after that date.

(B) Transition rule. For business entities created or organized under the laws of more than one jurisdiction as of August 12, 2004, the rules of subsection (b)(9) of this regulation apply as of May 1, 2006. These entities, however, may rely on the rules of subsection (b)(9) of this regulation as of August 12, 2004.

(4) The reference to the Estonian, Latvian, Liechtenstein, Lithuanian, and Slovenian entities in subsection (b)(8)(A) of this regulation applies to such entities formed on or after October 7, 2004, and to any such entity formed before such date from the date any person or persons, who were not owners of the entity as of October 7, 2004, own in the aggregate a 50 percent or greater interest in the entity. The reference to the European Economic Area/European Union entity in subsection (b)(8)(A) of this regulation applies to such entities formed on or after October 8, 2004.

(5) The reference to the Bulgarian entity in subsection (b)(8)(A) of this regulation applies to such entities formed on or after January 1, 2007, and to any such entity formed before such date from the date that, in the aggregate, a 50 percent or more interest in such entity is owned by any person or persons who were not owners of the entity as of January 1, 2007. For purposes of the preceding sentence, the term interest means--

(A) In the case of a partnership, a capital or profits interest; and

(B) In the case of a corporation, an equity interest measured by vote or value.

Note: Authority cited: Sections 19503 and 23038, Revenue and Taxation Code. Reference: Sections 17039, 17941, 18633.5, 23036 and 23038, Revenue and Taxation Code.

Section 23038(b)-3 is amended to read:

§ 23038(b)-3. Classification of Certain Business Entities

(a) In general. A business entity that is not classified as a corporation under Reg. §23038(b)-2(b)(1), (3), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes as provided in Treas. Regs §301.7701-3. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under Reg. §23038(b)-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner. Paragraph (b) of Treas. Regs. §301.7701-3 provides a default classification for an eligible entity that does not make an election. Thus, federal elections are necessary only when an eligible entity chooses to be classified initially as other than the default classification or when an eligible entity chooses to change its classification. An entity whose classification is determined under the default classification retains that classification (regardless of any changes in the members' liability that occurs at any time during the time that the entity's classification is relevant as defined in subsection (d) of this regulation) until the entity makes an election to change that classification under paragraph (c)(1) of Treas. Regs. §301.7701-3. Paragraph (c) of Treas. Regs. §301.7701-3 provides rules for making express elections. Subsection (c) of this regulation provides that for purposes of the taxes imposed by Part 11 of the Revenue and Taxation Code (Corporation Tax Law, commencing with Revenue and Taxation Code section 23001), the classification of an eligible business entity shall be the same as the classification of the entity for federal purposes and that if the separate existence of a business entity is disregarded for federal tax purposes, the separate existence of that business entity shall be disregarded. No separate election is allowed. Subsection (d) of this regulation provides special rules for foreign eligible entities. Subsection (e) of this regulation provides special rules for classifying entities resulting from partnership terminations and divisions under Section 708(b) of the Internal Revenue Code. Subsection ~~(f)~~ (h) of this regulation sets forth the effective date of this regulation and a special rule relating to prior periods.

(b) Classification of eligible entities that do not file an election--(1) Domestic eligible entities. Except as provided in subsection (b)(3) of this regulation, unless the entity elects otherwise, a domestic eligible entity is--

(A) A partnership if it has two or more members; or

(B) Disregarded as an entity separate from its owner if it has a single owner.

(2) Foreign eligible entities--(A) In general. Except as provided in subsection (b)(3) of this regulation, unless the entity elects otherwise, a foreign eligible entity is--

1. A partnership if it has two or more members and at least one member does not have limited liability;

2. An association if all members have limited liability; or

3. Disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.

(B) Definition of limited liability. For purposes of subsection (b)(2)(A) of this regulation, a member of a foreign eligible entity has limited liability if the member has no personal liability for the debts of or claims against the entity by reason of being a member. This determination is based solely

on the statute or law pursuant to which the entity is organized, except that if the underlying statute or law allows the entity to specify in its organizational documents whether the members will have limited liability, the organizational documents may also be relevant. For purposes of this regulation, a member has personal liability if the creditors of the entity may seek satisfaction of all or any portion of the debts or claims against the entity from the member as such. A member has personal liability for purposes of this subsection even if the member makes an agreement under which another person (whether or not a member of the entity) assumes such liability or agrees to indemnify that member for any such liability.

(3) Federal classification of existing eligible entities. (A) In general. Unless the entity elects otherwise, an eligible entity in existence prior to ~~the effective date of this regulation~~ January 9, 1998, will have the same classification for federal tax purposes that the entity claimed under repealed Treas. Regs. §301.7701-1 through 301.7701-3 as in effect on the date prior to ~~the effective date of this regulation~~ January 9, 1998; except that if an eligible entity with a single owner claimed to be a partnership under those regulations, the entity will be disregarded as an entity separate from its owner under this subsection (b)(3)(A) for federal tax purposes. For special rules regarding the classification of such entities ~~for periods~~ prior to ~~the effective date of this regulation~~ January 9, 1998, see subsection ~~(f)~~(h)(2) of Treas. Regs. §301.7701-3.

(B) Special rules. For purposes of subsection (b)(3)(A) of this regulation, a foreign eligible entity is treated as being in existence prior to ~~the effective date of this regulation~~ January 9, 1998, only if the entity's classification was relevant (as defined in subsection (d) of this regulation) at any time during the sixty months prior to ~~the effective date of this regulation~~ January 9, 1998. If an entity claimed different classifications prior to ~~the effective date of this regulation~~ January 9, 1998, the entity's classification for purposes of subsection (b)(3)(A) of this regulation is the last classification claimed by the entity. If a foreign eligible entity's classification is relevant prior to ~~the effective date of this regulation~~ January 9, 1998, but no California income tax, franchise tax, or information return is filed or the California income tax, franchise tax, or information return does not indicate the classification of the entity, the entity's classification for the period prior to ~~the effective date of this regulation~~ January 9, 1998, is determined under the regulations in effect on the date prior to ~~the effective date of this regulation~~ January 9, 1998.

(4) California classification of existing entities. (A) Notwithstanding subsection (c) of this regulation (related to requirement that an eligible business entity shall be classified or disregarded for tax purposes the same as the entity is classified or disregarded for federal tax purposes), an eligible business entity which, for any income year beginning within the sixty-month period preceding ~~the effective date of this regulation~~ January 9, 1998, was properly classified as an association taxable as a corporation for California income and franchise tax purposes under Revenue and Taxation Code section 23038 and the regulations thereunder, as in effect during such period, shall continue to be classified as an association taxable as a corporation until it irrevocably elects to be classified or disregarded for California income and franchise tax purposes the same as the entity is classified or disregarded for federal tax purposes.

(B) Election to be classified or disregarded the same as federal. 1. Election. An existing eligible business entity that, pursuant to subparagraph (A) of this subsection, is classified as an association taxable as a corporation for California income and franchise tax purposes for taxable or income years beginning on or after January 1, 1997, and, under Treas. Regs. §301.7701-3, is, without election, classified as a partnership or disregarded for federal tax purposes for taxable years beginning on or after January 1, 1997, may elect to be classified as a partnership or disregarded for California income and franchise tax purposes for taxable years beginning on or after ~~the effective date of this regulation~~ January 9, 1998, by filing an election to be classified or

disregarded the same as the entity is classified or disregarded for federal tax purposes. An election under this subparagraph must be in writing, and will not be accepted unless all the information required by forms and instructions, including the taxpayer identification number of the entity and the information required by Revenue and Taxation Code sections 18633 or 18633.5, as applicable, is provided. See Treas. Regs. §301.6109-1 for rules on applying for and displaying Employer Identification Numbers.

2. Effective date of election. The election shall be effective on the date specified in the written election or on the date filed if no date is specified in the written election. Except with regard to an election filed within 90 days following the date this regulation is filed with the Secretary of State, the effective date specified in the written election can be no more than 90 days prior to the date on which the election is filed and no more than 12 months after the date on which the election is filed. An election filed within 90 days following the date this regulation is filed with the Secretary of State may specify an effective date of January 1, 1997.

3. Irrevocable election. If an eligible entity makes an election under subsection (b)(4)(B) of this regulation to be classified or disregarded the same for California income and franchise tax purposes as the eligible business entity is classified or disregarded for federal tax purposes, the election is irrevocable. However, the Franchise Tax Board, on a showing of fraud, mistake of fact, or other good cause, may permit the entity to rescind its election to be classified or disregarded for California income and franchise tax purposes the same as the entity is classified or disregarded for federal tax purposes.

4. Authorized signatures. An election made under subsection (b)(4)(B) of this regulation must be signed by each member of the electing entity who is an owner at the time the election is filed; or any officer, manager, or member of the electing entity who is authorized (under local law or the entity's organizational documents) to make the election and who represents to having such authorization under penalties of perjury. If an election under paragraph (b)(4)(B) of this regulation is to be effective for any period prior to the time that it is filed, each person who was an owner between the date the election is to be effective and the date the election is filed, and who is not an owner at the time the election is filed, must also sign the election.

(c) Federal tax classification binding for California income and franchise tax purposes. (1) In general. Except as provided in subsection (b)(4) of this regulation, the classification of an eligible business entity for California income and franchise tax purposes shall be the same as the classification of the eligible business entity for federal tax purposes under Treas. Regs. §301.7701-3. The election of an eligible business entity to be classified as an association or a partnership for federal tax purposes shall be binding for California income and franchise tax purposes. Except as provided in subsections (b)(4) and (c)(2) of this regulation, if the separate existence of an eligible business entity is disregarded for federal tax purposes, the separate existence of the eligible business entity shall be disregarded for purposes of Part 10 (Personal Income Tax Law commencing with Revenue and Taxation Code section 17001), Part 10.2 (Administration of Franchise and Income Tax Law commencing with Revenue and Taxation Code section 18401), and Part 11 (Corporation Tax Law commencing with Revenue and Taxation Code section 23001). An election to be disregarded for federal tax purposes shall be binding for purposes of Part 10 (Personal Income Tax Law commencing with Revenue and Taxation Code section 17001), Part 10.2 (Administration of Franchise and Income Tax Law commencing with Revenue and Taxation Code section 18401), and Part 11 (Corporation Tax Law commencing with Revenue and Taxation Code section 23001).

(2) Disregarded entities. Except as provided in subsection (b)(4) of this regulation, if the separate existence of an eligible business entity is disregarded for federal tax purposes, the separate existence of the eligible business entity will be disregarded for purposes of Part 10 (Personal Income Tax commencing with Revenue and Taxation Code section 17001), Part 10.2 (Administration of Franchise and Income Tax Law commencing with Revenue and Taxation Code section 18401), and Part 11 (Corporation Tax Law commencing with Revenue and Taxation Code section 23001), subject to certain statutory provisions which recognize the existence of otherwise disregarded entities for certain purposes including the tax and fee of a limited liability company under Revenue and Taxation Code sections 17941 and 17942, the return filing requirements of a limited liability company under Revenue and Taxation Code section 18633.5, and the credit limitations of a disregarded entity under Revenue and Taxation Code sections 17039 and 23036.

(3) Notification of federal election. An eligible entity required to file a California income tax, franchise tax, or information return for the taxable year for which an election is made under paragraph (c)(1)(i) of Treas. Regs. §301.7701-3 must attach a copy of its federal Form 8832 (or any successor form) to its California income tax, franchise tax, or information return for that year. If the entity is not required to file a California income tax, franchise tax, or information return for that year, a copy of its federal Form 8832 must be attached to the California income tax, franchise tax, or information return of any direct or indirect owner of the entity for the taxable year of the owner that includes the date on which the election was effective. An indirect owner of the entity does not have to attach a copy of the federal Form 8832 to its return if an entity in which it has an interest is already filing a copy of the federal Form 8832 with its return. If an entity, or one of its direct or indirect owners, fails to attach a copy of a federal Form 8832 to its return as directed in this subsection, an otherwise valid election under paragraph (c)(1)(i) of Treas. Regs. §301.7701-3 will not be invalidated, but the non-filing party may be subject to penalties, including any applicable penalties if the California franchise tax or income tax or information returns are inconsistent with the entity's election under paragraph (c)(1)(i) of Treas. Regs. §301.7701-3.

(d) Special rules for foreign eligible entities--(1) Definition of relevance -- (A) General rule. Definition of relevance. For purposes of this regulation, a foreign eligible entity's classification is relevant when its classification affects the liability of any person for California income tax, franchise tax, or information purposes. For example, a foreign entity's classification would be relevant if California source income was paid to the entity and the determination by the withholding agent of the amount to be withheld under the Revenue and Taxation Code (if any) would vary depending upon whether the entity is classified as a partnership or as an association. Thus, the classification might affect the documentation that the withholding agent must receive from the entity, the type of tax or information return to file, or how the return must be prepared. The date that the classification of a foreign eligible entity is relevant is the date an event occurs that creates an obligation to file a California income tax, franchise tax, or information return, or statement for which the classification of the entity must be determined. Thus, the classification of a foreign entity is relevant, for example, on the date that an interest in the entity is acquired which will require a California person to file an information return.

(B) Deemed relevance – 1. General rule. For purposes of this regulation, except as provided in subsection (d)(1)(B)2. of this regulation, the classification for California income tax or franchise tax purposes of a foreign eligible entity that files Form 8832, "Entity Classification Election", shall be deemed to be relevant only on the date the entity classification election is effective.

2. Exception. If the classification of a foreign eligible entity is relevant within the meaning of subsection (d)(1)(A) of this regulation, then the rule in subsection (d)(1)(B)1. of this regulation shall not apply.

(2) Entities the classification of which has never been relevant. If the classification of a foreign eligible entity has never been relevant (as defined in subsection (d)(1) of this regulation), then the entity's classification will initially be determined pursuant to the provisions of subsection (b)(2) of this regulation when the classification of the entity first becomes relevant (as defined in subsection (d)(1)(A) of this regulation).

~~(2)~~ (3) Special rule when classification is no longer relevant.-- If the classification of a foreign eligible entity ~~which was previously relevant for California income and franchise tax purposes ceases to be relevant for sixty consecutive months,~~ is not relevant (as defined in subsection (d)(1) of this regulation) for 60 consecutive months, then the entity's classification will initially be determined ~~under the default classification~~ pursuant to the provisions of subsection (b)(2) of this regulation when the classification of the foreign eligible entity ~~again~~ becomes relevant (as defined in subsection (d)(1)(A) of this regulation). The date that the classification of a foreign entity ~~ceases to be~~ is not relevant is the date an event occurs that causes the classification to no longer be relevant, or, if no event occurs in a taxable year that causes the classification to be relevant, then the date is the first day of that taxable year.

(4) Effective date. Subsections (d)(1)(B), (d)(2), and (d)(3) of this regulation apply on or after October 22, 2003.

(e) Coordination with Section 708(b) of the Internal Revenue Code. Except as provided in Reg. §23038(b)-2(d)(3) (regarding termination of grandfather status for certain foreign business entities), an entity resulting from a transaction described in section 708(b)(1)(B) of the Internal Revenue Code (partnership termination due to sales or exchanges) or Section 708(b)(2)(B) of the Internal Revenue Code (partnership division) is a partnership.

(f) Changes in number of members of an entity -- (1) Associations. The classification of an eligible entity as an association is not affected by any change in the number of members of the entity.

(2) Partnerships and single member entities. An eligible entity classified as a partnership becomes disregarded as an entity separate from its owner when the entity's membership is reduced to one member. A single member entity disregarded as an entity separate from its owner is classified as a partnership when the entity has more than one member. If an elective classification change under paragraph (c) of Treas. Regs. § 301.7701-3 is effective at the same time as a membership change described in this subsection (f)(2), the deemed transactions in subsection (g) of this regulation resulting from the elective change preempt the transactions that would result from the change in membership.

(3) Effect on sixty month limitation. A change in the number of members of an entity does not result in the creation of a new entity for purposes of the sixty month limitation on elections under paragraph (c)(1)(iv) of Treas. Regs. § 301.7701-3.

(4) Examples. The following examples illustrate the application of this subsection (f):

Example 1. A, a U.S. person, owns a domestic eligible entity that is disregarded as an entity separate from its owner. On January 1, 1998, B, a U.S. person, buys a 50 percent interest in the entity from A. Under this subsection (f), the entity is classified as a partnership when B acquires an interest in the entity. However, A and B elect to have the entity classified as an association effective on January 1, 1998. Thus, B is treated as buying shares of stock on January 1, 1998. (Under paragraph (c)(1)(iv) of Treas. Regs. § 301.7701-3, this election is treated as a change in

classification so that the entity generally cannot change its classification by election again during the sixty months succeeding the effective date of the election.) Under subsection (g)(1) of this regulation, A is treated as contributing the assets and liabilities of the entity to the newly formed association immediately before the close of December 31, 1997. Because A does not retain control of the association as required by section 351 of the Internal Revenue Code, A's contribution will be a taxable event. Therefore, under section 1012 of the Internal Revenue Code, the association will take a fair market value basis in the assets contributed by A, and A will have a fair market value basis in the stock received. A will have no additional gain upon the sale of stock to B, and B will have a cost basis in the stock purchased from A.

Example 2. (i) On April 1, 1998, A and B, U.S. persons, form X, a foreign eligible entity. X is treated as an association under the default provisions of subsection (b)(2)(A) of this regulation, and X does not make an election to be classified as a partnership. A subsequently purchases all of B 's interest in X.

(ii) Under subsection (f)(1) of this regulation, X continues to be classified as an association. X, however, can subsequently elect to be disregarded as an entity separate from A. The sixty month limitation of paragraph (c)(1)(iv) of Treas. Regs. § 301.7701-3 does not prevent X from making an election because X has not made a prior election under paragraph (c)(1)(i) of Treas. Regs. § 301.7701-3.

Example 3. (i) On April 1, 1998, A and B, U.S. persons, form X, a foreign eligible entity. X is treated as an association under the default provisions of subsection (b)(2)(A) of this regulation, and X does not make an election to be classified as a partnership. On January 1, 1999, X elects to be classified as a partnership effective on that date. Under the sixty month limitation of paragraph (c)(1)(iv) of Treas. Regs. § 301.7701-3, X cannot elect to be classified as an association until January 1, 2004 (i.e., sixty months after the effective date of the election to be classified as a partnership).

(ii) On June 1, 2000, A purchases all of B 's interest in X. After A's purchase of B's interest, X can no longer be classified as a partnership because X has only one member. Under subsection (f)(2) of this regulation, X is disregarded as an entity separate from A when A becomes the only member of X. X, however, is not treated as a new entity for purposes of paragraph (c)(1)(iv) of Treas. Regs. § 301.7701-3. As a result, the sixty month limitation of paragraph (c)(1)(iv) of Treas. Regs. § 301.7701-3 continues to apply to X, and X cannot elect to be classified as an association until January 1, 2004 (i.e., sixty months after January 1, 1999, the effective date of the election by X to be classified as a partnership).

(5) Effective date. This subsection (f) applies as of November 29, 1999.

(g) Elective changes in classification -- (1) Deemed treatment of elective change -- (A) Partnership to association. If an eligible entity classified as a partnership elects under paragraph (c)(1)(i) of Treas. Regs. § 301.7701-3 to be classified as an association, the following is deemed to occur: The partnership contributes all of its assets and liabilities to the association in exchange for stock in the association, and immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners.

(B) Association to partnership. If an eligible entity classified as an association elects under paragraph (c)(1)(i) of Treas. Regs. § 301.7701-3 to be classified as a partnership, the following is deemed to occur: The association distributes all of its assets and liabilities to its shareholders in

liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership.

(C) Association to disregarded entity. If an eligible entity classified as an association elects under paragraph (c)(1)(i) of Treas. Regs. § 301.7701-3 to be disregarded as an entity separate from its owner, the following is deemed to occur: The association distributes all of its assets and liabilities to its single owner in liquidation of the association.

(D) Disregarded entity to an association. If an eligible entity that is disregarded as an entity separate from its owner elects under paragraph (c)(1)(i) of Treas. Regs. § 301.7701-3 to be classified as an association, the following is deemed to occur: The owner of the eligible entity contributes all of the assets and liabilities of the entity to the association in exchange for stock of the association.

(2) Effect of elective changes -- (A) In general. The tax treatment of a change in the classification of an entity for federal tax purposes by election under paragraph (c)(1)(i) of Treas. Regs. § 301.7701-3 is determined under all relevant and applicable provisions of the Internal Revenue Code, the California Revenue & Taxation Code, and general principles of tax law, including the step transaction doctrine.

(B) Adoption of plan of liquidation. For purposes of satisfying the requirement of adoption of a plan of liquidation under section 332 of the Internal Revenue Code, unless a formal plan of liquidation that contemplates the election to be classified as a partnership or to be disregarded as an entity separate from its owner is adopted on an earlier date, the making, by an association, of an election under paragraph (c)(1)(i) of Treas. Regs. § 301.7701-3 to be classified as a partnership or to be disregarded as an entity separate from its owner is considered to be the adoption of a plan of liquidation immediately before the deemed liquidation described in subsection (g)(1)(B) or (C) of this regulation. This subsection (g)(2)(B) applies to elections filed on or after December 17, 2001. Taxpayers may apply this subsection (g)(2)(B) retroactively to elections filed before December 17, 2001, if the corporate owner claiming treatment under Internal Revenue Code section 332 and its subsidiary making the election take consistent positions with respect to the federal tax and the California franchise and income tax consequences of the election.

(3) Timing of election -- (A) In general. An election under paragraph (c)(1)(i) of Treas. Regs. § 301.7701-3 that changes the classification of an eligible entity for federal tax and California franchise and income tax purposes is treated as occurring at the start of the day for which the election is effective. Any transactions that are deemed to occur under this subsection (g) as a result of a change in classification are treated as occurring immediately before the close of the day before the election is effective. For example, if an election is made to change the classification of an entity from an association to a partnership effective on January 1, the deemed transactions specified in subsection (g)(1)(B) of this regulation (including the liquidation of the association) are treated as occurring immediately before the close of December 31 and must be reported by the owners of the entity on December 31. Thus, the last day of the association's taxable year will be December 31 and the first day of the partnership's taxable year will be January 1.

(B) Coordination with Internal Revenue Code section 338 election. A purchasing corporation that makes a qualified stock purchase of an eligible entity taxed as a corporation may make an election under section 338 of the Internal Revenue Code regarding the acquisition if it satisfies the requirements for the election, and may also make an election to change the classification of the target corporation. If a taxpayer makes an election under section Internal Revenue Code 338

regarding its acquisition of another entity taxable as a corporation and makes an election under paragraph (c) of Treas. Regs. § 301.7701-3 for the acquired corporation (effective at the earliest possible date as provided by paragraph (c)(1)(iii) of Treas. Regs. § 301.7701-3), the transactions under subsection (g) of this regulation are deemed to occur immediately after the deemed asset purchase by the new target corporation under section 338 of the Internal Revenue Code.

(C) Application to successive elections in tiered situations. When elections under paragraph (c)(1)(i) of Treas. Regs. § 301.7701-3 for a series of tiered entities are effective on the same date, the eligible entities may specify the order of the elections on Form 8832. If no order is specified for the elections, any transactions that are deemed to occur in this subsection (g) as a result of the classification change will be treated as occurring first for the highest tier entity's classification change, then for the next highest tier entity's classification change, and so forth down the chain of entities until all the transactions under this subsection (g) have occurred. For example, Parent, a corporation, wholly owns all of the interest of an eligible entity classified as an association (S1), which wholly owns another eligible entity classified as an association (S2), which wholly owns another eligible entity classified as an association (S3). Elections under paragraph (c)(1)(i) of Treas. Regs. § 301.7701-3 are filed to classify S1, S2, and S3 each as disregarded as an entity separate from its owner effective on the same day. If no order is specified for the elections, the following transactions are deemed to occur under this subsection (g) as a result of the elections, with each successive transaction occurring on the same day immediately after the preceding transaction S1 is treated as liquidating into Parent, then S2 is treated as liquidating into Parent, and finally S3 is treated as liquidating into Parent.

(4) S corporations. An eligible entity that timely elects to be an S corporation under Internal Revenue Code section 1362(a)(1) is treated as having made an election under this regulation to be classified as an association, provided that (as of the effective date of the election under Internal Revenue Code section 1362(a)(1)) the entity meets all other requirements to qualify as a small business corporation under Internal Revenue Code section 1361(b). Subject to Treas. Regs. § 301.7701-3(c)(1)(iv), the deemed election to be classified as an association will apply as of the effective date of the S corporation election and will remain in effect until the entity makes a valid election, under Treas. Regs. § 301.7701-3(c)(1)(i), to be classified as other than an association.

(5) Effective date. Except as otherwise provided in subsection (g)(2)(B) of this regulation, this subsection (g) applies to elections that are filed on or after November 29, 1999. Taxpayers may apply this subsection (g) retroactively to elections filed before November 29, 1999 if all taxpayers affected by the deemed transactions file consistently with this subsection (g).

~~(f)~~ (h) Effective date--(1) In general. Except as otherwise provided in this section, ~~T~~the rules of this regulation are effective for taxable or income years commencing on or after January 1, 1997.

(2) Prior treatment of existing entities. In the case of a business entity that is not described in Reg. §23038(b)-2(b)(1), (3), (4), (5), (6), or (7), and that was in existence prior to January 1, 1997, the entity's claimed classification(s) will be respected for all periods prior to January 1, 1997, if--

(A) The entity had a reasonable basis (within the meaning of Section 6662 of the Internal Revenue Code) for its claimed classification;

(B) The entity and all members of the entity recognized the California income and franchise tax consequences of any change in the entity's classification within the sixty months prior to January 1, 1997; and

(C) Neither the entity nor any member was notified in writing on or before May 8, 1996, that the classification of the entity was under examination (in which case the entity's classification will be determined in the examination).

(3) Deemed elections for S corporations. Section (g)(4) of this regulation applies to timely S corporation elections under section 1362(a) of the Internal Revenue Code filed on or after July 20, 2004. Eligible entities that filed timely S elections before July 20, 2004 may also rely on the provisions of the regulation.

Note: Authority cited: Sections 19503 and 23038, Revenue and Taxation Code.
Reference: Sections 17039, 17941, 18633.5, 23036 and 23038, Revenue and Taxation Code.

Section 23038(b)-5 is adopted to read:

§ 23038(b)-5. Domestic and foreign business entities.

(a) Domestic and foreign business entities. For purposes of Regs. §§ 23038(b)-1, 23038(b)-2, and 23038(b)-3, a business entity (including an entity that is disregarded as separate from its owner under Reg. § 23038(b)-2(c)) is domestic if it is created or organized as any type of entity (including, but not limited to, a corporation, unincorporated association, general partnership, limited partnership, and limited liability company) in the United States, or under the law of the United States or of any State. Accordingly, a business entity that is created or organized both in the United States and in a foreign jurisdiction is a domestic entity. A business entity (including an entity that is disregarded as separate from its owner under Reg. § 23038(b)-2(c)) is foreign if it is not domestic. The determination of whether an entity is domestic or foreign is made independently from the determination of its corporate or non-corporate classification. See Regs. §§ 23038(b)-2 and 23038(b)-3 for the rules governing the classification of entities.

(b) Examples. The following examples illustrate the rules of this regulation:

Example 1. (i) Facts. Y is an entity that is created or organized under the laws of Country A as a public limited company. It is also an entity that is organized as a limited liability company (LLC) under the laws of State B. Y is classified as a corporation for California income and franchise tax purposes under the rules of Regs. § 23038(b)-2 and § 23038(b)-3.

(ii) Result. Y is a domestic corporation because it is an entity that is classified as a corporation and it is organized as an entity under the laws of State B.

Example 2. (i) Facts. P is an entity with more than one owner organized under the laws of Country A as an unlimited company. It is also an entity that is organized as a general partnership under the laws of State B. P is classified as a partnership for California income and franchise tax purposes under the rules of Regs. § 23038(b)-2 and § 23038(b)-3.

(ii) Result. P is a domestic partnership because it is an entity that is classified as a partnership and it is organized as an entity under the laws of State B.

(c) Effective date. -- (1) General rule. Except as provided in subsection (c)(2) of this regulation, the rules of this regulation apply as of August 12, 2004, to all business entities existing on or after that date.

(2) Transition rule. For business entities created or organized under the laws of more than one jurisdiction as of August 12, 2004, the rules of this regulation apply as of May 1, 2006. These entities, however, may rely on the rules of this regulation as of August 12, 2004.

Note: Authority cited: Sections 19503 and 23038, Revenue and Taxation Code.
Reference: Sections 17039, 17941, 18633.5, 23036 and 23038, Revenue and Taxation Code.